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IMP MONTHLY REPORT | AUGUST 2020

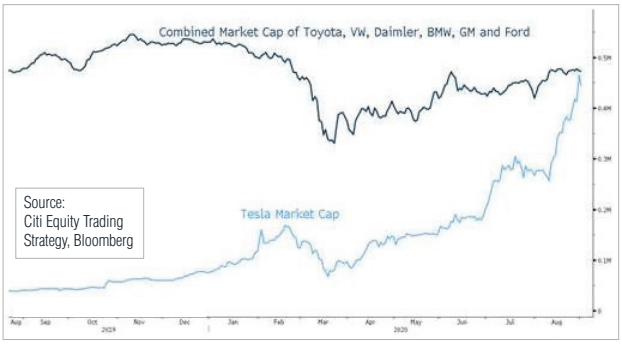
Report by Toby Grimm

August was another strong month, as global markets continued their remarkable recovery from the March lows amidst ongoing optimism regarding reopening, and the progress of a myriad of potential COVID-19 vaccines and treatments.

The local market

The Australian market (S&P/ASX 200 Index) was up 2.2%, its fifth consecutive monthly gain, culminating in a technical new high on August 25. While positive for investors locally, our market lagged US markets substantially as they posted 7% plus gains and the S&P 500 Index joined the Nasdaq at all time highs.

The rising weight of Technology (and those reclassified old 'Tech' names such as Amazon, Facebook and Alphabet) helped drive Wall Street's out-performance and the sector's investor appeal due to resilient (and in many cases, boosted) revenue amidst COVID-19, with longer term secular growth potential supported by largely impressive quarterly reports. Nonetheless, the staggering performance of mega-cap US tech stocks has been amazing, and clearly there is scope for a rotation towards other value sectors (i.e. those with real businesses that have been effected by COVID-19 rather than those built on future hope with little to no current profitability to be hit). The chart below highlights this:



Locally, we saw stellar performances by many of our Tech names and discretionary retailers, however, in Australia these have a proportionately smaller index weighting, with larger exposure to laggards such as Financials and Materials (each up ~1% for the month).

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Arguably, the strength of the Australian Dollar also weighed on performance (in $USD terms, our market's 5.6% return in August was above average globally), as did a generally disappointing domestic reporting season (certainly in regards to mega-capitalisation stocks including BHP, CSL and Telstra). While minimal, it does appear a short term top has been put in place on the $AUD with the RBA action and statement this week proving more 'pro-active' and dovish than expected, while the USD appears to be finding support. A cessation in the $AUD's ascent, and even some mild retracement, will help our overseas operators, as well as Materials and Energy sectors, in the coming months, should commodity prices remain well supported.

Individually Managed Portfolios (IMP)

Unfortunately for our IMP models it was a difficult month, resulting in a average under-performance of 136bp (100I –235bp, 100T -211bp, 200 -76bp and 300 -25bp). Refer to our Portfolio & Yield reports for more detail, however, the outcome was larger misses at the lower risk, larger end, while the more aggressive 200 and 300 models faired far better.

As is usually the case in August, we also suffered a substantial Ex-Dividend timing issue in the month, worth an average 55bp, which we will receive in coming months.

Clearly, cash averaging ~9% was a headwind for us, and frankly we were underweight in two sectors which out-performed (Information Technology up 15.5% in the

month, and Consumer Discretionary 8.7 %), so composition certainly played a role.

Our key IT exposure, Appen, also reported slightly disappointing results and fell 21% in the last three days of the month, taking its monthly performance to -2.6% (costing us over 60bp in the 200 and 300 models).

To be fair, we have been guilty of under-appreciating the depth and longevity of the retail spurt in Consumer Discretionary, and this also cost us relative performance. Quite simply, stimulus and prolonged restrictions have extended the runway for major retailers and it now appears they will enjoy relatively well supported conditions through to the key Christmas period.

Of course, we will monitor the sector, however, we are very mindful of the incredibly high watermark the sector is creating at present, and while FY21 may be a nominal and relative belter, in FY22 it is going to be extremely difficult for these store owners to repeat, let alone improve, on this year's numbers. Hot money may feel safe for now, but reality is coming sooner or later.

Obviously, while micro stock-up level analysis and selection adjustments are necessary (as always), given the thematic and momentum driven reasons for our underperformance in August, we do believe we will see out-performance from mean reversion in coming months.

Also unsurprisingly, the YMP missed by 143bp with a similarly large Ex-Dividend mismatch. With 10% cash, 18% Income Securities (which generally reflect ~ 20% of the move in equity markets), and a skew towards large dividend paying companies (essentially the worst performers in the last few months), it is not a surprise that the YMP failed to keep up with buoyant equity markets in their fifth month of a massive rally.

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Market outlook and commentary

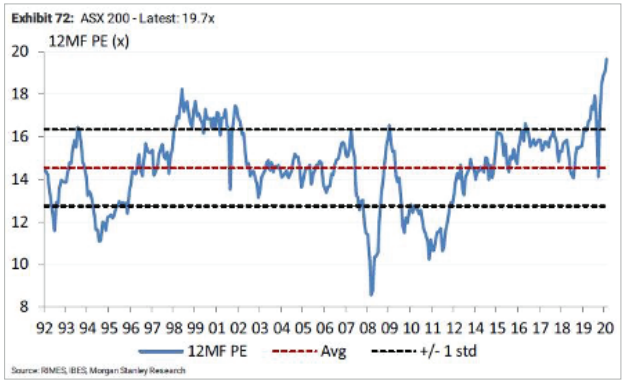
In short, little has changed other than persistent trends have further stretched valuations, and the passage of time does bring us closer to genuine re-opening with medical support.

As has been the case since March, the existence of and promise of more, as per the US Federal Reserve's confirmation that it will use an average approach to inflation targets rather than a hard 2% limit (this was repeatedly signalled in recent years, so shouldn't be ground-breaking, but it does highlight the likely length of support), Fiscal and Monetary support has kept a bid on risk assets – particularly any that have shown resilient earnings (or revenue) growth like the technology sector and online retail.

The apparent receding in the US second wave (and more recently here in Victoria, alongside continued relative successful defence in NSW and QLD), has also helped spur more cyclical names and a recovery in some of the sectors most impacted by restrictions.

Commodity prices have generally remained well supported, reflecting both improving underlying demand (global manufacturing data has been better than expected, consumer spending is holding up and government investment in infrastructure remains a key thematic globally) and recent weakness in the US Dollar (which we believe may have run its short-term course). However, after a disappointing reporting season locally where Earnings estimates for the ASX 200 declined by several percentage points compared to immediately prior, the market looks very stretched fundamentally. At nearly 20x forward earnings, it is more expensive than any point in its ~30-year history. Dividends were a positive, however, as companies prioritised distributions over investment in future growth.

Guidance was scant, and those who provided guidance (eg CSL, AGL,TLS, APX) were arguably punished for doing so. We believe the provision of guidance is a positive not a negative, and that these forecasts are likely conservative given the environment. Over the coming 6 to 12 months we believe those who have guided are likely to beat, while those who haven't (and whose share price fared better as a result) are more at risk of disappointing, fuelling some mean reversion there. The chart below, courtesy of Morgan Stanley Research, highlights the unprecedented multiple...



Two things are occurring here. Firstly, the EPS estimate is probably underestimating the ultimate reality. While FY20 EPS forecasts have drifted from -15% to -17%, FY21 has actually ticked up 1% (to flat) and, based on historic trends (with markets leading estimates), it appears likely this may prove to be more like +3-5%. Should this happen the P/E is probably closer to 18.5x which, while still expensive relative to historic averages, is less so, especially when considered against a backdrop of record low interest rates (which have the effect of reducing substitute returns and reducing the required earnings return accordingly).

We have been told interest rates aren't moving for several years, and confidence in ultra-low rates has forced money into markets demanding lower risk compensation (i.e. prepared to pay a higher price/multiple for the same income stream). This trend is unlikely to change but we do feel it is very stretched at current and consequently are not 'chasing' higher growth/multiple plays on momentum alone. We are also mindful that while it seems virtually impossible for central banks to achieve 2% let alone higher levels necessitating 'average targeting', inflation is a very poorly understood phenomenon and historically, once it starts to gather pace, it can rise exponentially very quickly. If, as a result of massive increases in monetary supply (QE) this begins to occur, we think the Fed and other central banks will be a lot more nervous about letting it 'run hot' than they can comfortably say now where there is no perceivable risk of it occurring near term. In short, inflation rises to 2% quickly and the Fed will pull the rug. But that is a tail risk at the moment (and one that investors should probably demand some compensation for).

After rallying steadily for five months it certainly appears a period of consolidation is likely. Certainly the inside selling seen in recent days suggests the same (XRO, WTC, TYR and others). Interestingly figures released this week show Australia's Future Fund virtually doubled its cash holdings (as a % of its investment portfolio) during the June Quarter (arguably a bit early, and mostly from unlisted 'illiquid' investments but also listed Equities).

The coming few months will involve a local and US budget with potential Fiscal stimulus. However, in the US, with markets at all time highs, it appears there is little to no pressure for Congress to push anything through pre-election. The affluent voters are enjoying record stock prices (for now... a big market correction = pressure to agree on stimulus...), and lower income voters are focussed on social justice. The Election is presently a line ball call – admittedly with the market not really 'liking' either candidate (but also not really 'fearing' them either).

As we've said in previous months, there is heightened risk Trump decides to use foreign policy as a political tool in the lead up to the election. If this occurs alongside prolonged inability for Congress to agree on stimulus, markets may just succumb to a long awaited pull back. Indeed, as I write it may be occurring with Wall St suffering its worst single day loss in 3 months for no apparent reason... other than the S&P 500 Relative Strength Indicator was at 83.5. This is considered a general indication that the market is overbought in the short-term.

But there will also be positives, with continued good news on vaccine and treatment fronts (the US CDC reportedly this week advising US state entities to ready distribution networks for a possible November 1 roll-out of a vaccine), and we expect a continued gradual improvement in economic data reflecting the patchy reopening.

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We are not bearish but we do think the US market is ready for consolidation and, unfortunately, as much as we have underperformed, the reality is it is near impossible for the Australian market to rally in the face of falling US stocks. From a technical perspective we continue in a tightening pennant and have, arguably, seen some slightly concerning technical damage in the past week.

As much as we remain in a recovery uptrend (with higher major highs and lows), on 2 September we fell through a significant uptrend support line. We rallied back to it on the 3rd but it, which corresponds to the 200 day Moving Average, also proved resistant and we have subsequently dropped back to (and presently through) the very influential pivot line (below). There appears to be no significant resistance at ~6,100 (trend line, 200 Day MA and 20 day MA) above which the double top 6,200 remains resistant.

Breaking through support, rallying back to it and it holding as resistance is a bearish short term signal. If we take out the recent low (5,909) it would suggest a move to the first Fibonacci retracement (which aligns with a series of lows in April and May – the higher oval in the chart below) and a reasonable likelihood of a proper retracement to 50% of the rally (which aligns with a series of highs in March and April) at around 5,500 – the top of the box. This would be about 10% from the recovery highs.

Meanwhile, the long term chart remains in the trend, but highlights the fact that we rallied to the top of the box (61.8% retracement of the COVID fall) and failed to break through it. A retest of the uptrend channel lower band would spell ~ 5,780 (which corresponds to the first area of support on the daily chart prior) and then a retest of the December 2018 lows at ~ 5,600.

Overall, we remain pragmatic that suppressed interest rates and the promise of further Fiscal stimulus will likely maintain support on any pull back. The eventual flow of good news on the pandemic front will do likewise. We expect to use any short term weakness on a well overdue pull back to deploy further cash across both quality growth and value opportunities as they are presented.

Good luck, stay safe and hopefully we will see better performance in September.